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Students' Department

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The examination questions of the American Institute of Accountants are now used by thirty-two state C. P. A. boards as well as by the institute. Readers of THE JOURNAL OF ACCOUNTANCY who were candidates in the November examinations conducted by these boards or by the institute are, therefore, already familiar with the problems. These solutions, it should be understood, merely represent the opinion of the editor of this department and are not official solutions by the institute.

SOLUTIONS OF AMERICAN INSTITUTE OF ACCOUNTANTS' EXAMINATIONS

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II—(*Continued*)

Question 4:

Indicate by appropriate journal entries the various debits and credits you would make in setting up the following reserves for a balance-sheet, explaining briefly how you would determine the proper amount of each reserve.

(a) Reserve for bad and doubtful debts.
(b) Reserve for trade discounts.
(c) Reserve for cash discounts.
(d) Reserve for state, county and city taxes accrued.

Answer, Question 4:

(a) Reserve for bad and doubtful debts.

Debit bad debts.
Credit reserve for bad and doubtful debts.
To set up a reserve for estimated loss on bad debts.

Debit reserve for bad and doubtful debts.
Credit accounts receivable.
To charge off account ascertained to be worthless.

The amount to set aside in the reserve would be determined from experience as to bad debt losses in the past or by examining all the accounts receivable and estimating the probable loss in collecting them. The losses on accounts arising from sales of various years may be divided by the sales of the respective years to obtain a rate of loss based on sales. The sales of the current year would then be multiplied by this rate, modified in the light of any information indicating that future losses would be greater or less than the losses in the past. Or the annual losses may be divided by the accounts receivable at the beginning of the year to determine the rate of loss. This rate would be applied to the accounts receivable at the date of the balance-sheet to determine the total desired reserve. The amount to set up would be the difference between the reserve already on the books and the desired reserve. This method has the advantage of reducing the carrying value of the accounts receivable to their estimated realizable value at the date of the balance-sheet, but it has the disadvantage that the reserve will probably be called upon to absorb losses not only on the accounts on the books at the date of the balance-sheet but also on accounts arising during the next year, and it may therefore prove to be inadequate.

(b) Reserve for trade discounts. It is difficult to understand what object a company could have in setting up such a reserve. Operating reserves are intended to record a decrease in an asset already taken place, such as the reserve for depreciation, a possible or probable loss in the realization of an asset, such as the reserve for bad debts, or a liability, such as a reserve for taxes. A reserve for trade discounts would not seem to be necessary unless there is some uncertainty as to whether or not customers will take advantage of the trade discounts offered. But there is no contingency about true trade discount. The trade discount is deducted on the invoice, and the customer is charged with only the net amount after deducting the discount. After the customer's account has been charged with only the net amount, trade discounts cannot further decrease the amount collected.

(c) Reserve for cash discount. There is a contingency in the case of cash discount, for the customer may pay the bill within the discount period or he may fail to do so and lose the discount. If it is desired to value the accounts receivable at the net amount less the discount, it will be necessary to estimate from the records what per cent of the accounts are usually paid by customers within the discount period. This per cent will then be applied to the total open accounts subject to discount and not past due, to ascertain the probable cash discount which will be taken by customers.

Debit discount on sales.
    Credit reserve for cash discounts.
To set up a reserve of the amount of the probable cash discounts to be taken by customers in settling their accounts.

Cash.
Reserve for cash discounts.
    Accounts receivable.
To show settlement of an account, the discount being charged to the reserve,

(d) Reserve for state, county and city taxes accrued. This reserve would be credited with an amount ascertained by estimating the assessed valuation of the taxable property, multiplying by the tax rate and multiplying this product by the fraction representing the portion of the tax year which has expired.

> Debit taxes.
> Credit reserve for taxes.
> To set up a reserve for the estimated accrued property taxes at this date.

If this reserve is accrued monthly the entire amount of the taxes paid will be charged against the reserve:

> Debit reserve for taxes.
> Credit cash.
> To record payment of property taxes.

If there is a credit balance in the reserve it should be closed out, the credit being made to surplus and profit and loss in the proportion in which the over-accruals applied to the prior year and to the current year.

If the reserve is set up merely at the end of the year, and no monthly accruals are made, the portion of taxes applicable to the prior year will be charged against the reserve and the balance will be charged to taxes as a current expense. The balance of the reserve, whether a debit or a credit, should be closed to surplus.

Question 5:

It is now becoming quite common practice for corporations to insure the lives of their principal officers, so that upon their deaths the corporations may be, in a measure, reimbursed for the loss to the business. You are asked to indicate what sort of entries would be made by a company, from time to time, if it paid the insurance premiums on a policy of insurance for $50,000.00 carried on the life of its president under the four classes of insurance policies indicated below:

Ten-year renewable term policy.
Twenty-payment life policy.
Straight life policy.
Twenty-year endowment policy.

Also indicate what entries should be made in the books for the receipt of the $50,000.00 principal of the different classes of policies, supposing the president of the company died during the fifth year of the insured term.

Answer, Question 5:

10-Year renewable term policy. Under this policy there is no cash surrender value, and the total annual premium should be charged as an expense. At the rate of $13.49 per thousand at the age of 35, the annual premium on $50,000.00 would be $674.50, and the annual entries would be as indicated in the following table. In all the illustrations in this solution the matter of dividends is ignored, as there is no information as to whether they are applied in reduction of the premiums or in additions on the policy. If applied against the premiums the effect would be merely a reduction of the amount of the entry charging premiums and crediting cash.

TABLE OF ENTRIES

Beginning of year	Debit Life insurance premiums	Credit Cash
1	$674.50	$674.50
2	674.50	674.50
3	674.50	674.50
4	674.50	674.50
5	674.50	674.50

Entry for collection of policy during the fifth year:

Debit cash	$50,000.00	
Credit surplus		$50,000.00

20-Payment life policy. This policy has a cash surrender value—in most companies at the end of the third year. This cash surrender value is an asset which continually increases with the life of the policy. At the end of the third year it should be put on the books, with offsetting credits to surplus for two-thirds of the value, or the amount applicable to the first two years, and to life insurance premiums for one-third, or the amount applicable to the current year; and this one-third represents a reduction of the premium expense for the year. At the beginning of each year thereafter there should be an entry for the payment of the premium, and at the end of the year an entry showing the increase in the cash surrender value. At the rate of 33.13 per thousand at the age of 35 the entries would be as tabulated below:

TABLE OF ENTRIES

Year	Debit Cash sur. val.—Life ins. policy	Debit Life ins. premiums	Credit Life ins. premiums	Credit Cash	Credit Surplus
1—Beginning		$1,656.50		$1,656.50	
2—Beginning		1,656.50		1,656.50	
3—Beginning		1,656.50		1,656.50	
3—End	$2,400.00		$800.00		$1,600.00
4—Beginning		1,656.50		1,656.50	
4—End	1,150.00			1,150.00	
5—Beginning			1,656.50		1,656.50

Entry for collection of policy during the fifth year:

Debit cash	$50,000.00	
Credit cash surrender value—life insurance policy		$ 3,550.00
Surplus		46,450.00

Straight-life policy. The entries during the first five years would be the same as under a 20-payment life policy, excepting as to amount.

TABLE OF ENTRIES

Year	Debit Cash sur. val.—Life ins. policy	Debit Life ins. premiums	Credit Life ins. premiums	Credit Cash	Credit Surplus
1—Beginning..		$1,244.50		$1,244.50	
2—Beginning..		1,244.50		1,244.50	
3—Beginning..		1,244.50		1,244.50	
3—End.......	$1,150.00		$ 383.00		$ 767.00
4—Beginning..		1,244.50		1,244.50	
4—End.......	$ 700.00		700.00		
5—Beginning..		1,244.50		1,244.50	

Entry for collection of policy during the fifth year:

Debit cash............................	$50,000.00	
Credit cash surrender value—life insurance policy....................		$ 1,850.00
Surplus		48,150.00

20-Year endowment policy. As this policy has a cash surrender value, the entries will be of the same nature as those already described. Still using the age of 35, the entries at the rate of $47.12 per thousand would be:

TABLE OF ENTRIES

Year	Debit Cash sur. val.—Life ins. policy	Debit Life ins. premiums	Credit Life ins. premiums	Credit Cash	Credit Surplus
1—Beginning..		$2,356.00		$2,356.00	
2—Beginning..		2,356.00		2,356.00	
3—Beginning..		2,356.00		2,356.00	
3—End.......	$4,450.00		$1,483.00		$2,967.00
4—Beginning..		2,356.00		2,356.00	
4—End.......	1,950.00		1,950.00		
5—Beginning..		2,356.00		2,356.00	

Entry for collection of the policy during the fifth year:

Debit cash............................	$50,000.00	
Credit cash surrender value—life insurance policy....................		$ 6,400.00
Surplus		43,600.00

Question 6:

In examining the accounts of a corporation engaged in the manufacture of a variety of articles in respect of which a specification cost system is maintained as an integral part of the bookkeeping (which, so far as inventories and cost are concerned, forms the basis of the monthly financial accounts comprising balance-sheet and profit and loss account), you find a large discrepancy between the total value of the physical inventory of manufactured stock and work in progress, as priced at specification costs and the corresponding general ledger account, the physical inventory value being substantially less than the relative book values. What investigation would you expect to make to ascertain the cause of the discrepancy? What factors would you expect to find contributing to it? And how would you dispose of the discrepancy? And upon what theory would you recommend that adjustment be made?

Answer, Question 6:

In a specification cost system, the manufacturing accounts are charged with the actual expenses and credited with finished product and work in process at the specification costs. The finished product account and the goods in process account are therefore book inventories, and any discrepancy between actual and estimated costs will appear as a balance in the manufacturing account. If the estimates are too high the costs will be over-absorbed and the manufacturing account will have a credit balance. If the estimates are too low the costs will be under-absorbed and the manufacturing account will have a debit balance.

The question states that the specification costs are the basis of the book inventories used in the monthly balance sheet and profit and loss statement, and it also states that the physical inventory is priced at specification costs. Therefore the two inventories should agree unless there are errors in the computation or differences in the count. A difference in the count might be caused by:

(a) Fewer goods finished than were recorded as finished, resulting in an over-statement of the book inventory of finished goods.

(b) Fewer goods put into process than were recorded as put into process, resulting in an over-statement of the book inventory of goods in process.

(c) Goods removed from stock without recording their removal.

(d) Articles overlooked in making the count.

The first three of these possible causes indicate carelessness in handling the cost records or possible theft. Causes (a) and (b) would be adjusted by a recomputation of cost on the basis of the actual quantities finished and put into process, with an adjustment of the earnings to the extent of the change in cost of articles sold and an adjustment of the inventory to the extent of the change in the cost of articles unsold. In the case of (c), if the goods were sold without record, there would be a charge to cost or sales and a credit to finished goods. If the goods were stolen, the charge would be to surplus. Cause (d) would be ascertained by a recount, the only adjustment required being a change in the amount of the physical inventory.

The statement of the question to the effect that the book inventories and physical inventories were both priced at specification costs limits the causes of the discrepancy to error in quantities or in computations. Ordinarily, however, the point of interest in a specification cost system is the variation between actual cost and specification cost, and this variation is measured by the under-absorption or over-absorption of cost appearing as a balance in the manufacturing account rather than as a discrepancy between the book and physical inventories. When it becomes apparent that the costs are not correctly absorbed the cause should be ascertained.

The first step would be a comparison of the actual material cost with the corresponding specification cost to ascertain whether there are any important variations or not. A similar procedure should be followed for labor; and of course there would be a comparison of the actual factory overhead expenses with the estimated amount included in the specification costs.

In regard to the raw material, the examination will consist of a comparison of actual invoice prices with the specification cost used, particular attention being given to whether or not freight, discount, storeroom charges and similar items have been handled uniformly—that is, if included in the specification material cost, they should be included in the material accounts on the books and not in the other accounts.

As to labor, there will be two elements to consider: labor rates and the unit cost of production. A check will be made to ascertain if the labor rates actually paid are the same as the labor rates used in the specification costs, and if overtime paid, bonuses, etc., are handled similarly in the ledger accounts and in the specification costs.

The unit cost of production is apt to disclose serious errors. For instance, it was found in one case that the employees over-reported the quantity of work performed, with the result that the factory showed a lower cost of labor per unit than the actual cost; and this lower cost was used in the specification costs, resulting in a very material under-absorption of labor costs in cost of sales as well as in work in process and finished product.

The discrepancy in burden will undoubtedly exist, because if the volume of actual production is materially in excess of the estimated volume there is apt to be over-absorption of burden, and, on the contrary, if the volume of production is materially less than expected there is apt to be under-absorption.

After the various factors have been analyzed, an effort should be made to allocate the discrepancies as between inventories of finished products and work in process and cost of goods sold, the purpose of the adjustment being to state the inventories at cost.

Question 7 (optional):

What could a purchaser who wished to realize 3 per cent on his investment give for a bond for $10,000.00 which had four years to run at 5 per cent interest, payable yearly, and thereafter was payable with a bonus of 10 per cent?

Solution, Question 7:

1 ÷ 1.03 = .97087379 P. V. @ 3% of 1 due 1 period, hence
.97087379 ÷ 1.03 = .94259591 P. V. @ 3% of 1 due 2 periods, hence
.94259591 ÷ 1.03 = .91514166 P. V. @ 3% of 1 due 3 periods, hence
.91514166 ÷ 1.03 = .88848705 P. V. @ 3% of 1 due 4 periods, hence

Present value of par and premium:

$11,000.00 × .88848705 = ... $ 9,773.36

Present value of coupons:

1.00 — .88848705 = .11151295 compound discount, .11151295 ÷ .03 = 3.717098 P. V. of annuity of 1 $500.00 (annual coupons) × 3.717098 =	1,858.55
Price	$11,631.91

Proof-Table of Amortization

End of year	Debit Cash	Credit Interest	Credit Bond account	Balance
				$11,631.91
1	$ 500.00	$ 348.96	$151.04	11,480.87
2	500.00	344.43	155.57	11,325.30
3	500.00	339.76	160.24	11,165.06
4	500.00	334.95	165.05	11,000.01
	$2,000.00	$1,368.10	$631.90	

EXAMINATION IN AUDITING

November 16, 1920, 9 A. M. to 12:30 P. M.

Answer all the following questions:

Question 1:

You are called upon to audit the accounts of a large railroad system. State shortly what its sources of income are, what records you would expect to find containing the details of them, how they are generally summarized in order to bring them on the books of the company, and how you would satisfy yourself of their accuracy.

Answer, Question 1:

If enough students of accounting were interested in the subject of railroad accounts to justify the use of the necessary space, it might be desirable to devote a series of articles in this department to answering this question. The assistant comptroller of a large railroad with general offices in Chicago was asked to "state shortly what its sources of income are." The following is condensed from his statement, which occupied three single-spaced typewritten pages:

This railway company derives its revenue from the following sources:

Freight revenue. The freight earnings are derived from the handling of local freight, and this carrier's proportion of freight handled on through way-bills on basis of tariff rates. Also the transportation of mail matter and empty pouches at freight tariff rates. Revenue received from reconsigning privileges, stop privileges and transit privileges are also credited to freight revenue.

Passenger revenue, the earnings derived from the transportation of passengers, based on regular tariff fares. The sources of these earnings are from the sale of local tickets, this company's proportion of foreign tickets sold by our agents and foreign tickets sold by agents of other lines to destinations on this company's lines. This also includes mileage scrip honored and conductors' cash fare collections, as well as the surcharge recently added to sleeping-car fares.

Excess baggage, revenue derived from the transportation of baggage in excess of the authorized allowance, which is usually 150 pounds, and from the transportation of articles such as baby carriages and bicycles.

Sleeping car revenue, derived from the sale of berth and seat accommodations in sleeping cars.

Parlor and chair car revenue, derived from seat accommodations in parlor cars.

Mail revenue, amounts received from the United States post office department for the transportation of mail are credited to this account, and fines assessed by the government for failure properly and promptly to handle mail are charged to this account.

Express revenue, including amounts received from the express company for the transportation of express matter, and for the use of facilities on trains and at stations incident to such transportation.

Other passenger train revenue, from the transportation of packages, newspapers, dogs, etc., as well as lump sums received for transportation of passengers on regular or chartered trains in excess of the regular tariff fares.

Unclaimed penalty collections, the value of mileage books, coupons and scrip books unredeemed.

Milk revenue, from the transportation of cream, milk, etc., on the basis of tariffs at so much per package.

Switching revenue, received for switching cars loaded or emptied between connecting lines and between local industries or at industry plants.

Special service train revenue, earnings received for running trains either on the basis of a rate per mile or a lump sum rate for the train, including the handling of baggage cars in special trains for theatrical companies and the running of trains for federal and state governments for the transport of troops.

Other freight train revenue.

Dining and buffet revenue.

Hotels and restaurants,

Station, train and boat privileges.

Parcel room revenue.

Storage—freight.

Storage—baggage.

Demurrage.

Telegraph and telephone.

Stock yards, including revenue from feeding, watering and bedding live stock at company stock yards; also revenue from shearing and dipping sheep and cattle, stabling horses and inspecting live stock.

Rents of buildings and other property.

Miscellaneous revenue.

Joint facilities.

Revenue from miscellaneous operations, such as interest on track material borrowed by other companies.

Hire of freight cars.

Rent from locomotives.

Rent from passenger train equipment.

Rent from work equipment.

Income from lease of road.

Dividend income, covering dividends received on stocks owned.

Interest income, covering interest on bonds and other interest-bearing investments.

As to "what records you would expect to find containing the details of them, and how they are generally summarized in order to bring them on the books of the company," I am informed by a railroad accountant that "these records comprise something like fifty separate forms, which, of course, would be too lengthy to permit of their being described." And when so much space has been required merely to mention the sources of income, it would seem that a volume would be required for an adequate description of the procedure by which an auditor would satisfy himself of their accuracy. Certainly a reasonable proportion of the space devoted to answering the ten auditing questions is wholly inadequate.*

Question 2:

In auditing the accounts of a large corporation you find an account with Liberty bonds charged with $200,000.00, representing the cost of bonds subscribed and paid for by the company. At the date of the balance-sheet to which you are to certify, the bonds had a market value of $187,500.00. What attitude would you take as to their valuation in the balance-sheet?

Answer, Question 2:

There are two rules for the valuation of securities. In the case of dealers in securities, the rule is that the securities be valued at cost or market, whichever is lower, because the securities are stock in trade. When stocks or bonds are held as permanent investments by companies not dealing in them, the rule is that stocks be valued at cost, and that bonds be valued at cost plus the amortized discount or minus the amortized premium. Presumably the corporation referred to in the question is not a dealer in securities, and hence the second rule would apply. As the bonds were apparently purchased at par, they should be shown on the balance-sheet at their cost, $200,000.00, there being no discount or premium to amortize. The market value might be shown in parentheses, but there is no necessity for doing so, because every one knows that Liberty bonds are quoted below par.

Question 3:

What do you understand by the terms

(a) Contingent assets?

(b) Contingent liabilities?

*[The editor of the *Students' Department* overlooks the phraseology of the question. The demand is that the candidate state "shortly." The board of examiners doubtless desired a list of the principal items which would occur readily to the average practising accountant or in fact to the ordinary man of business.—*Editor* THE JOURNAL OF ACCOUNTANCY.]

Give three illustrations of each.
Where would you look for items?
Should they be set up on the books of the company?
Should they appear on a certified balance-sheet of the company? If so, where and how stated?

Answer, Question 3:

A contingent asset is property the title to which may or may not vest in the claimant or an unacknowledged claim which may or may not develop into an unconditional receivable, depending on the outcome of a dispute or other uncertainty.

A contingent liability is a claim which is not at present a positive liability but may become one through the action or default of a third party or through the outcome of some other uncertainty.

When notes receivable have been discounted a contingent asset and a contingent liability have been created. If the debtor pays the note to the party to whom it has been negotiated the contingent asset does not develop into a real one and the contingent liability does not become real. But if the debtor does not pay, the endorser must. Thus the contingent liability becomes positive, and since the endorser has a claim against prior endorsers as well as the maker of the note, his contingent asset develops into a real asset. If the books have been properly kept, the facts would appear in the accounts, the contingent asset in the notes receivable account being offset by the contingent liability in the notes receivable discounted account. If discounted notes have been credited to the notes receivable account, a statement should be obtained from the client's bankers and note brokers as to the amount of unmatured discounted paper held by or disposed of through them. The facts would be shown on the certified balance-sheet by deducting the discounted notes from the total of the notes on hand and discounted. The contingent liability might also be shown short on the liability side.

A contingent asset will arise when a company has paid under protest a larger federal tax than it considers due and has instituted or intends to institute proceedings to recover. Such a claim would be found by examination of the company's tax records; or information might be received from the company's officers or attorney. It would usually be omitted from the accounts; and if set up on the balance-sheet it should be offset by a reserve.

There might be deposits of various sorts coming under the classification of contingent assets. When deposits have been made on account of court costs of a case not yet come to trial, the deposit would be a contingent asset dependent upon the outcome of the trial. It should appear in the accounts, separated from the cash, and in the balance-sheet under a heading clearly stating its nature.

Cumulative preferred stock dividends in arrears are contingent liabilities. The auditor would discover them by comparing the amount of dividends paid on the stock with the amount which should have been paid to fulfill all requirements. The books would not show the amount of the dividends in arrears, as no entry is made for dividends until they are declared. On the balance-sheet they should be shown by dividing the surplus, if it is in excess of the dividends in arrears, or by a footnote if the surplus is less than the unpaid dividends.

Pending law suits are contingent liabilities which might be found by examination of the minutes or by communication with the client's attorney. The liability would not appear on the books, and it is doubtful whether or not an auditor should insist on clearly showing it as such on the certified balance-sheet, as the client might object on the ground that the appearance of the item on the balance-sheet might be interpreted as an admission of liability. If the auditor believes there is a great probability of an adverse decision of the suit, he might insist on the creation of a reserve for contingencies which would have the effect of reducing the surplus without publishing what could be construed into an acknowledgment of the debt.

Question 4:

How may the amount of a merchant's stock on hand be estimated from time to time when it is not practicable to take a physical inventory more than once a year?

Answer, Question 4:

Stock on hand may be estimated at dates between the taking of physical inventories by applying the gross profit method. The rate of gross profit on sales since the last inventory may be estimated on the basis of the rate of gross profit earned on sales in prior periods. Any changes during the period in the cost or selling price of merchandise would have to be taken into consideration in estimating any probable variation between the rate earned in prior periods and the rate earned in the current period. The sales since the date of the last inventory would be multiplied by this estimated rate of gross profit to determine the estimated gross profit on the goods sold. Then the sales minus this estimated gross profit would be the estimated cost of goods sold since the last inventory. The opening inventory plus the purchases, freight and other additions to the cost of goods, minus the estimated cost of goods sold, would give the estimated inventory.

Question 5:

State concisely your understanding of the purpose of and the difference between the following kinds of audits, indicating briefly your conception in the absence of special instruction of the extent of your responsibility in each case, whose interests you would consider yourself obligated to protect, and the forms of certificates you would expect to furnish, assuming no qualifications were desired. Except where stated to the contrary, you may assume the audits relate to a corporation.

(a) Continuous or periodical cash audit.
(b) Annual audit.
(c) Financial audit or investigation.
(d) General audit of trustees' or executors' accounts for probate.
(e) Audit required under a patent infringement.

Answer, Question 5:

(a) A cash audit is one which has as its sole purpose the examination of cash records and supporting papers to determine whether there has been any error or fraud in handling the cash. The auditor is expected to safeguard only the interests of the corporation, and its interests only to the extent of the cash. The audit would be continuous if the auditor exercised supervision and made examinations at frequent intervals during the period. Otherwise it would be periodical.

Certificate

"I hereby certify that I have examined the cash records of the Blank Company for the year ended December 31, 1919, and find no evidence of uncorrected errors or of fraud."

(b) The term "annual audit" is vague, as a cash audit, a balance-sheet audit or a detailed audit would be an annual audit if conducted annually. Probably what is meant is an annual detailed audit. A detailed audit is such a comprehensive examination of the books and other records as will satisfy the auditor that the record of income and expenses during the period and of the assets and liabilities at the end of the period is correct as to facts and accounting principles. The auditor would be responsible not only to the corporation itself, but to all third parties who might rely on his report for information.

Certificate

"I have audited the accounts of the Blank Company for the year ended December 31, 1919, and I hereby certify that in my opinion the above balance-sheet and profit and loss statement correctly present the financial condition of the company at December 31, 1919, and the operations of the company for the year ended on that date."

(c) A financial audit or investigation involves such an examination as will enable the auditor to report to his client upon the present financial condition of the corporation, the earnings of at least one and probably several periods and the prospects for the future so far as they affect the probable repayment of the loan under consideration. The auditor would be responsible to the corporation for a true statement of its condition and to the bankers or other ultimate purchasers of the securities who relied on his report.

Certificate

"I have audited the accounts of the Blank Company for the ——— years ended December 31, 1919, and I hereby certify that the above statements in my opinion correctly present the operating earnings of the company for each of the ——— years, the financial condition of the company at December 31, 1919, and the condition after giving effect to the proposed re-financing."

(d) In an audit of executors' accounts for probate, the auditor should see that all the assets in the inventory of the estate have been taken into the accounts and verify all the transactions of the executors affecting the principal and income of the estate, assuring himself that the law and the terms of the will have been observed. In auditing the accounts of trustees he should see that they have taken up the assets of the trust as turned over by the grantor or the executors, and that the records as to principal and income are in conformity with the facts, the law and the provisions of the trust. The auditor should protect the interests of all beneficiaries, the trustees and executors and the court.

Certificate

"I have audited the accounts of ————, executors (or trustees) of the estate of ————, during the period from ———— to ————, and I hereby certify that the above summary statements correctly present the operations of the executors both as to principal and income, and that the foregoing balance-sheet is a correct statement of the financial condition of the estate at ————."

(e) An audit required under a patent infringement would be devoted to ascertaining the estimated profit which accrued to the corporation by reason of the infringement. The auditor would be responsible to the persons who engaged him to make the audit and it would be his duty to arrive at a fair and unbiased estimate.

Certificate

"I have audited the accounts of the Blank Company from ———— to ————, and I hereby certify that the foregoing statement in my opinion presents a reasonable estimate of the gross profit accruing to the Blank Company by reason of the alleged patent infringement, together with the proportion of expenses properly deductible therefrom."

Question 6:

What steps should be taken in the most complete possible verification of the capital stock account of a corporation in an audit for a year, if during that year the authorized capital was increased and new stock was issued and certain shares were acquired and held by the company (assuming that it is legal to do so), and if (a) there is a registrar of the stock and (b) there is not?

Answer, Question 6:

The capital stock account on the general ledger, minus the treasury stock account and the unissued stock account, would give the amount of stock purporting to be outstanding. This would be verified by listing the open stubs of the stock certificate book and the balances of the stockholders' accounts in the subsidiary stock ledger. The totals of these two lists should agree with the outstanding stock shown by the ledger. If there is a registrar of the stock, a certificate would be obtained from him as to the amount outstanding, but in as complete a verification as possible the foregoing comparisons would be made whether there is a registrar or not. As to the new issue, the auditor should see that it was authorized by the stockholders or directors, if the latter were empowered to do so, and by the proper state officer, and the subscription lists and cash records should be verified. The vouchers for the purchase of the treasury stock should be examined. If a transfer journal is kept the entries therein should be verified by reference to the cancelled certificates.

Question 7:

State definitely the procedure you would follow in verifying the liability of a corporation on account of notes payable as shown by its books.

Answer, Question 7:

The audit of notes payable should involve two things: determining whether or not the business received value for the notes—which would be accomplished by examining the vouchers underlying the transactions—and determining whether or not there are any unrecorded notes payable. The search for unrecorded notes payable would involve the following:

An analysis should be made of the interest account to find whether there was a recorded note corresponding to every interest payment or not. The client's bank should be asked for a statement of the notes held by it. If there is any evidence to indicate that money is borrowed from other sources, statements should be requested from them as to the amount of paper held. If creditors are asked for statements, it might be desirable to ask for the liability on notes as well as on accounts. If credits appear in the partners' capital accounts during the year, it is possible that these credits arose from investments of the proceeds of notes which are a liability of the business. If credits appear in officers' accounts it is possible that the corporation is liable on notes for loans which have been credited to these personal accounts instead of to notes payable; hence such payments should be investigated. If purchases of fixed assets appear on the books, it is possible that the purchases have been made on an instalment basis and the fixed asset accounts have been charged with payments made while notes are outstanding for the bulk of the purchase price. Therefore the auditor should ascertain whether the charges represent the entire purchase price or only that portion which has been paid.

Question 8:

You ae engaged by bankers to undertake an investigation of a business incidental to a proposed refinancing. The instructions from the bankers are received subsequent to the date of the balance-sheet which you are expected to certify. How would you proceed to verify the asset of cash, explaining the necessity for each step?

Answer, Question 8:

I would obtain the bank's statement in the client's office of the date of the balance-sheet, count the cash on hand at the date of the audit and ask the bank for a statement of its account with the client at the same date. I would then check the cashier's reconciliation of the bank account of the date of the balance-sheet and make a reconciliation of the date of the audit, thus determining the outstanding cheques and any other differences at the two dates. All entries for cash receipts and cash payments between the two dates should be verified by vouchers and returned cheques to see that all cash received has been recorded and that all cash credits represent actual disbursements. Otherwise a shortage at the balance-sheet date might be covered by unrecorded receipts or by fictitious entries for disbursements. Then, to the sum of the cash on hand at the date of the audit and the bank balance at the same date there should be added the disbursements made since the date of the balance-sheet. From this total should be deducted the receipts for the same fractional period as shown by the cashbook. The resulting figure would represent the balance on hand at the date of the balance-sheet, which should be compared with the balance shown in the balance-sheet.

Question 9:

Draft forms of certificates for inventory and outstanding liabilities of a manufacturing business with which you are familiar, stating nature of the business.

Answer, Question 9:

It is most unusual for an auditor to certify merely to the inventory or merely to the outstanding liabilities of a business, and it is consequently difficult to understand what is required by the question. Usually the auditor would certify the balance-sheet and profit and loss statement as a whole and not any particular elements of them. If an occasion should arise in which an auditor was instructed to verify only these items, his certificates might be somewhat as follows: "I have verified the inventory of the Blank Company as of ———, and hereby certify that in my opinion the quantities are correct, and that each item is correctly priced at cost or market whichever was lower at the date of the inventory." Or, "I have examined the accounts and records of the Blank Company and hereby certify that in my opinion the balance-sheet of ——— discloses all the liabilities of the company outstanding at that date."

It is not unlikely that the question refers to the certificates which the auditor might require from officers and employees of the corporation. In the matter of inventory, the auditor might require a certificate from each person engaged in the preparation thereof, as follows:

"I hereby certify that I participated in preparing the inventories of December 31, 1919, by:

"Ascertaining quantities on hand, and I know of no understatement or overstatement thereof.

"Pricing; the raw material was priced at (cost), (market), (cost of market whichever was lower).

the goods in process were priced at ———

the finished goods were priced at ———

"Extending.

"Footing."

(Signed) ———————

As to liabilities, an officer of the corporation might be required to certify somewhat as follows:

"I hereby certify that all liabilities known by me to be existing at December 31, 1919, appear on the books at that date."

(Signed) ———————

Question 10:

In auditing the books of a corporation you find that certain officers, apparently without any authorization, are indebted heavily to the corporation. How would you proceed in such circumstances?

Answer, Question 10:

Usually such a condition is not indicative of fraud. It is merely evidence of an indifference to the legal requirements in regard to corporate funds. It may indicate a laxness so great as to induce fraud on the part of the officers. The auditor should call attention to the fact that the most charitable interpretation which can be put on such drawings is to call them loans, which would be subject to recovery if required for the payment of liabilities, and that the least charitable interpretation is to call them misappropriations. If the withdrawals are legitimate they should be authorized; in any event the attention of the directors should be called to their irregularity. Debit balances of this kind are often found in close corporations, particularly if the business has previously been conducted as a partnership. The former partners, having become accustomed to taking drawings, continue to do so, not realizing that partners may be allowed to take drawings in any free and easy manner they desire, while the profits of a corporation can be legally divided only by the formal declaration of a dividend. If these accounts represent drawings against an accumulated surplus account, the auditor should advise the declaration of a dividend to cover, so as to legalize the withdrawals and relieve the stockholders of liability to creditors on account thereof in the event of future financial difficulties.